CBO TESTIMONY

Statement of
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Congressional Budget Office

before the
Subcommittee on Readiness
Committee on Armed Services
U.S. House of Representatives

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Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to discuss the public policy and budgetary implications of the Defense Business Operations Fund (DBOF). This is an appropriate time for such a review. The authorization for DBOF expires within a year, the Secretary of Defense has ordered a review of this management initiative, and the Vice President's Performance Review group has expressed interest in DBOF as a possible case study of government reform.

My statement makes three points:

- The idea behind DBOF is promising--that is, to use internal markets and business-type organizations within the Department of Defense (DoD) to increase operating efficiency and improve oversight of support services.

- To realize this promise, however, a number of changes are required in the structure and operating practices of the fund.

- Reform is urgently needed to assure DBOF's financial integrity and to establish that prices charged by support services are based on relevant and reliable measures of costs.

NEED FOR CHANGE

A number of concerns have been raised about the performance of the support services of the Department of Defense. Principal among these are that:

- o Inventory stocks are excessive,
- o Services are provided inefficiently,
- o Costs are too high, and
- o Prices do not accurately reflect cost.

To this list of complaints, DBOF has added:

- o Ability of the defense fund to generate and misuse cash,
- o Undisciplined transfers of funds between DBOF and other accounts for reasons unrelated to support operations, and
- o Diminished capacity of the Congress to exercise oversight of DoD because of DBOF.

Although DBOF was established to improve performance in support activities and facilitate oversight, it does not appear to have achieved its goals. In assessing this initiative, it is useful to review the beginnings of DBOF in earlier DoD reforms.

Predecessors of DBOF

For many years, DoD has been attempting to create a customer/business-provider relationship between its military operating units and its support services. The goal is for the support services to finance themselves by selling their products at full cost to the operating units. Incentives to provide high-quality services at low costs are expected to be strengthened by making support activities compete for customers and revenue.

The inspiration for this reform comes from differences in performance between military and civilian support services. Thousands of private firms routinely and efficiently meet the support service needs of the civilian world for fuel, food, clothing, shelter, laundry, transportation, aircraft and motor vehicle repair, printing, and accounting. They provide these services without any central authority ordering them to do so or telling them how or when to do it. They do so because it is in their own self-interest to meet the demands

of their customers at the lowest possible cost. The "invisible hand" described by Adam Smith is at work here guiding the efforts and energies of millions of people into those activities where value is maximized.

The attempt to increase efficiency in DoD support services by making these entities more like their private-sector counterparts can probably be traced to 1950 when industrial revolving funds were created to finance such support services as equipment repair, shipyards, laundries, clothing manufacturing, and jewel-bearing production. A revolving fund is a budget account in which collections from the sale of services are supposed to pay for a continuing cycle of operations.[1] These accounts highlight the balance (or imbalance) between collections and outlays for a government activity. Because revolving fund activities are intended to break even, use of a revolving fund has the potential to improve oversight of support activities by showing the extent to which the activity is financing its outlays from collections.

Before the revolving funds and priced services were established, support services were financed from accounts that were directly appropriated. Under this form of budgetary control, managers of supply operations were more concerned with the availability of funding from various appropriations (and

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1. Technically, a revolving fund is an expenditure account that is authorized to be credited with collections.

with spending it all) than they were with controlling the costs of producing services.[2] In addition, operating units--quite reasonably--regarded support services as "free" and used them more liberally than if they were required to pay for these services out of their own budgets. Priced services give some assurance that services supplied and paid for are actually needed.

Based on the favorable experience with industrial funds, revolving fund financing was eventually extended to suppliers of spare parts, food, fuel, tents, medical supplies, and cots, for example. Gradually, too, the elements of cost included in the price have increased.

Changes Made by DBOF

The Defense Business Operations Fund is another step in the process of putting DoD support services on a business basis without privatization. Adopting DBOF further increased the number of support activities that are accounted for in federal revolving funds, consolidated the accounting of balances with the Treasury, and created a management opportunity to standardize financial policies throughout DoD.

2. General Accounting Office, *27 Years' Experience with Defense Industrial Funds, FGMSD-76-51 (October 5, 1976), pp. 12-13.*

Revolving Fund Coverage. Many, but not all, DoD support services are now financed from the DBOF revolving fund. These services include maintenance of depots for ships, aircraft, vehicles, and ordnance; supply management and distribution; transportation; commissaries; production of clothing; and Navy research and development activities that were already in separate revolving fund accounts. In addition, the fund incorporates activities that were formerly funded with direct appropriations, such as accounting and technical information services.

Consolidated "Cash." Before DBOF, each of the revolving funds managed its own balance with the Treasury to ensure that its balance was always adequate to meet its spending plans. Traditionally, DoD revolving funds have not had the authority to borrow from the Treasury to finance short-term cash imbalances. When DBOF was established, the sum of Treasury balances held by the previous accounts amounted to \$6.5 billion (see Table 1). DoD anticipated that economies of scale in these holdings would permit the balance to be drawn down to \$4.1 billion by the end of 1992 and \$3.7 billion by the end of 1993.

Standardized Financial Policies. The DBOF initiative also provided an opportunity for standardizing policies and practices among the various support activities. Overhead costs, labor costs, military personnel, and depreciation

TABLE 1. DBOF STATEMENT OF FINANCIAL CONDITION (By fiscal year, in billions of dollars)

	Actual	Projected	
	1991	1992	1993
Assets			
Fund balance with the Treasury	6.5	4.1	3.7
Accounts receivable	5.3	5.0	5.0
Inventories	55.6	94.8	94.1
Other assets	3.1	2.7	2.8
Capital property	13.6	15.2	20.2
Total	84.1	121.8	125.8
Liabilities			
Accounts payable	6.3	5.1	4.7
Accrued liabilities	3.3	2.8	2.6
Other liabilities	1.1	0.9	1.0
Total	10.7	8.8	8.3
Government Equity	73.4	113.0	117.5

SOURCE: Congressional Budget Office based on data from the Office of the Secretary of Defense, *DBOF Overview*, vol. I (February 1992).

for new capital equipment are to be included in the prices charged by all support activities. Policy also mandates that prices vary with the cost of the level of service provided. These changes would make prices more inclusive of costs and more comparable among suppliers.

CONFLICTING REQUIREMENTS OF THE BUSINESS MODEL AND DOD

The business model is a promising alternative to a command-and-control approach to support management. Yet, many of the necessary preconditions for the success of the private-sector model are not present in the Department of Defense. In particular, many policies and practices of the department conflict with and require modifications in the competitive market model, if DoD is to use the business approach productively.

Essential Elements of the Competitive Business Model

Some of the indispensable attributes of a competitive market solution to coordinating and controlling production and distribution are consumer sovereignty, free competition, business-like financing, and reliable accounting.

Consumer Sovereignty. With the business model, the customer is king. Under this approach, buyers must be free (subject to a budget constraint) to purchase those items that they believe will best suit their needs. For DoD, this approach means that military units would be given substantial latitude to decide how to perform their assigned missions. Support agencies, in turn, would provide only those services that customers would be willing to pay for, nothing more or less.

A number of factors preclude military commanders from exercising consumer choice--for example, central defense policy, doctrine, planning of operations, approval of capital expenditures, and military specifications. To tailor the competitive market model to the special requirements of defense, some modifications will be required.

Free Competition. Competition among suppliers is necessary to assure that customers have choices and that they are not overcharged. Supply units will only have the appropriate incentives to deliver high-quality performance and control their costs if they are faced with competition from other providers. For DoD, this principle means that military units would need to have multiple alternatives for a service. For example, a commander would have to be authorized to shop around and make cost comparisons for equipment repair, food and fuel, and transport services. If a sufficient level of competition

could not be achieved within DoD to ensure such customer choice, the supply process would need to be opened to private suppliers.

Some of these conditions cannot be met within an organization that must fight as a single unit. Each military commander cannot decide on the supplies and equipment to use and still fight as part of a team. Other conditions necessary for the market approach to work are clearly at odds with many of the changes DoD has made in organizing its support activities. For example, consolidating supply operations at both the wholesale and retail levels has eliminated many potential competitors. Central management of transportation services, the current practice of spreading work around to all the service depots, and legal limitations on contracting out reduce the scope for arm's-length competition that is necessary to discipline the support effort. DoD has centralized the management of these activities to take advantage of perceived economies of scale and avoid duplication of effort, but the competitive business model requires decentralized management with many independent suppliers. Either central management and provision of these services will have to be given up or the business model must be tailored to deal with this lack of competition.

Business-Type Financing. No business is financed by an interest-free grant of resources. Rather, all true businesses are financed by owners and creditors

who provide the enterprise with resources to conduct the intended activity. In exchange for these resources, owners and creditors receive claims to interest and dividends. The social purpose of this exchange of claims is to assure that resources are allocated to their highest-valued uses, make prices inclusive of costs, and provide incentives to firm managers to economize on the use of resources.

DBOF, in contrast to the business model but like the revolving funds it has taken over, is "grant" financed. Its funding comes without financial strings. It operates without recognizing interest or the time-value of money. When the fund generates cash from drawing down inventories or overcharging customers, these funds are available for use (or misuse) outside the budget process. For DBOF, business-type financing means that the fund should pay for acquiring assets using debt rather than a free grant of monies and resources. Fortunately, as discussed below, this violation of the business model is not based on military considerations and could be corrected.

Reliable Accounting. To function effectively, businesses must be able to determine the cost of various activities and services provided to customers. They must also be able to monitor changes in costs. Without this information, firms will be unable to set prices to recover costs, evaluate changes in production methods, or assess their own performance. For the Department

of Defense, these standards mean that the support agencies must be able to measure costs accurately and reliably.

The weaknesses of DoD's financial accounting and information systems have been documented by this Subcommittee and the General Accounting Office and acknowledged by the department.[3] Time and resources will be required to improve these systems to the point that they can meet the needs of a reform based on raising the visibility and significance of measured costs.

Implications for DBOF

Despite many inconsistencies between current conditions and practices of DoD and the requirements for a competitive market in support services, the business model can contribute significantly to improving performance and oversight of these activities.

For example, using inadequate accounting systems and inappropriate financing and pricing may weaken rather than strengthen the defense effort.

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3. Letter of Chairman Earl Hutto, Subcommittee on Readiness, House Committee on Armed Services, to the Honorable Les Aspin, April 8, 1993; Statement of Donald H. Chapin, Assistant Comptroller General, before the Subcommittee on Readiness, House Committee on Armed Services, April 30, 1991 (GAO/T-AFMD-91-5); Letter of Donald H. Chapin to Chairman Ronald V. Dellums and Ranking Minority Member Floyd D. Spence, House Committee on Armed Services, March 1, 1993 (B-249045); and Office of the Secretary, Department of Defense, Defense Business Operations Fund, "Milestone I Status Report" (February 2, 1993).

That is, in a number of instances no conflict exists, and in others the conflict is not dictated by military considerations.

Even those practices that are grounded in the unique mission of the military do not apply with equal force to all support services. Activities such as laundry and dry cleaning, printing, housing, medical care, information services such as data processing, and commissaries may be appropriately reorganized around a competitive market model. And the competitive business model is not the only form of business enterprise that can be used to increase efficiency and improve oversight of DoD support services. Sole-provider, noncompetitive enterprises are often used in the civilian sector and ought to be considered for use in DoD.

In fact, most DBOF support services seem to be closer to the sole-provider, regulated model than the purely competitive system alluded to in many descriptions of the fund. One of the important elements missing from DBOF--if this regulated industry analogy is apt--is an independent authority to oversee and approve DBOF's pricing decisions.

SOME OPTIONS FOR REFORMING DBOF

Properly structured, DBOF can contribute to improved management in DoD. To realize this potential, however, some modifications in the current approach are required--for example, converting to business-type financing to assure the financial integrity of the fund and providing for market and nonmarket price discipline for DBOF.

Financial Structure and Fund Integrity

Perhaps the greatest single source of Congressional frustration with DBOF is the lack of budgetary control of, and the potential for misuse of resources in, the fund. These concerns have led Members to characterize DBOF as a "money machine for bureaucrats" and a "slush fund."

DBOF's dubious financial character arises because of its unbusinesslike financing, which enables it to generate "free" budgetary resources. Unlike a business enterprise, the fund has more than $100 billion in assets but owes virtually nothing to creditors or owners (see Table 1). Thus, when DBOF sells assets that it does not replace, it generates funds outside the budget

process that may used by those who control the fund. This practice is difficult to defend on grounds of good budgeting or good public policy.

One means of correcting this structural weakness would be to have DBOF reacquire the assets of the entities it has taken over and to finance this acquisition by borrowing the purchase price from the Treasury. The Congress would set the maximum amount to be borrowed through the authorizing and appropriation process. With control over the size of DBOF's line of credit at the Treasury, the Congress would have a direct means of controlling the rate at which activities are reincorporated into DBOF.

Because it is intragovernmental, the purchase would not require the government to borrow or use tax revenues. The transaction does assure, however, that DBOF will have an interest-bearing debt to the Treasury equal to the value of assets it acquires. In addition to giving the Congress direct control over the growth of DBOF (no activities could be added without increasing DBOF's line of credit from the Treasury), business-type financing would create a prior claim by the Treasury on all free funds generated by inventory drawdowns. It, therefore, eliminates both the "slush" of free resources and the threat of fund transfers.

Debt financing of DBOF activities subject to a Congressionally controlled line of credit would also solve the nagging cash problem. This Subcommittee has frequently asked the Pentagon to define a cash policy and specify the minimum cash needs of DBOF. Under interest-bearing debt financing, DBOF would have an incentive to hold a cash balance of approximately zero. Doing so would allow the DoD to minimize its financing charges. That is, rather than holding cash balances and paying interest on an equal amount of debt, DBOF would use any balance to pay down its line of credit to the Treasury and reduce its interest costs. Further, rather than using accumulated balances to finance purchases, DBOF would make use of its line of credit, which it would have to manage to assure that its unused line was adequate to finance spending requirements.

Debt financing of supply and support services would also correct the incentives that the service units now have to overstock items. Under current free financing, no incentive exists to hold down inventory stocks. In fact, the incentive is always to hold stocks in excess of needs just in case someone asks for the item. Recognizing the interest cost of holding assets in a revolving fund would force managers to balance these costs against the benefits of having the item on hand when requested. Including financing costs in prices is also consistent with the DBOF objective of comprehensive cost pricing.

This business-like financial structure will increase DoD's annual budget authority and outlays by the interest cost on the revolving fund's debt. Given the current size of DBOF and Treasury interest rates, this increase would be in the neighborhood of $8 billion per year. The corresponding increase in the DoD "top line" budget totals could lead to the perception that DoD's budget is larger than before the change. In fact, the increase reflects a pure budgetary accounting change rather than a change in budgetary resources available to DoD.

To assure that the balance between debt and assets is maintained in the future, the Congress would need to provide for the disposition of DBOF's operating gains and losses. All earnings should be paid to the Treasury to enable these unanticipated gains to be recycled through the budget process. In parallel fashion, losses incurred by DBOF should be paid for through appropriations. Both the payment and the appropriation should provide an occasion for Congressional review of DBOF operations.

Moreover, with business-type financing and treatment of gains and losses, DBOF will be able to report its financial performance to the Congress using straightforward commercial statements, including an operating statement and statement of condition. Earnings for each business-type activity would

indicate some minimum level of success; losses would indicate a need to take a closer look at operations.

Market and Regulatory Price Discipline

For reasons directly related to the unique security mission of the Department of Defense as well as some particular characteristics of these activities, not all--perhaps only a few--support services are fully compatible with the requirements for consumer sovereignty and free competition of the market model. DoD needs to identify those support activities that can be left to the decentralized choices of military commanders and other local consumers in a free market and those that cannot.

Although DoD has established a three-part standard to be used in qualifying activities for inclusion in DBOF, these standards are of little assistance in identifying those activities suitable for a competitive market environment.[4] DoD needs to use national defense criteria to further categorize DBOF activities as to their suitability to compete. Once support activities have been classified, the Congress and DoD might turn to one of the

4. Donald B. Shycoff, Principal Deputy Comptroller, Department of Defense, "DBOF Financial Policy and Responsibilities," Memorandum for DBOF Financial Policies Executive Board (July 2, 1991). The criteria are that the activity must have an identifiable output or product, that the costs of the business activity must be attributable to the output, and that the customers of the business activity must be identifiable.

most neglected aspects of the DBOF initiative: assuring that the prices charged by DBOF suppliers are subject to the discipline of either a competitive market or review by an independent price commission.

Activities judged suitable for competitive markets need to be placed in such an environment. To date, virtually no steps have been taken to increase competition in support services. Without competition, the market model is a prescription for prices that are too high. With competition in place, prices will be held down to close to cost, and costs will be as low as possible.

Activities judged to be unsuitable for the competitive market should have their prices subjected to an independent, arms-length review. This means that a panel accountable to the President and reporting to the Congress would have to approve DBOF prices before they could be put into effect.

One model for such a review process consists of the regulatory commissions established by the states and the federal government to oversee energy and transportation prices. Such a DBOF pricing commission could operate with a small staff if it were authorized to obtain material from DoD to justify prices. The commission could contribute to DBOF's success not only by raising the visibility and importance attached to the prices of support services. It could also serve as a forum for contractors who believe they can

supply needed services at lower cost. Commission hearings and proceedings would also provide the Congress with information that could be useful in conducting oversight and evaluation of DoD support services.

CONCLUSION

Markets and business-type organizations have the potential to increase the efficiency of DoD support services. But the business model must be applied consistently to include the requirements for business-type financing, and the correct form of the business model must be used. If based solely on the competitive business model, DBOF is not going to produce all the expected gains because the necessary preconditions for competitive markets are not present throughout DoD. DBOF has a better chance of achieving its promise provided that:

- DBOF activities are financed by interest-bearing debt rather than grants;

- Support services are designated as suitable either for competitive or regulated provision;

- Competitive services are subjected to effective competition; and

- An independent price regulator is established to set prices for noncompetitive services.

In sum, we believe that these changes would facilitate meeting the needs that motivated the creation of DBOF.